Frontispiece on Good Faith: A Functional Approach within the UCC

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Abstract
This article examines areas of the law with thin jurisprudences on good faith, and how the Uniform Commercial Code’s (UCC’s) express statutory rules have become an active laboratory of experiments on good faith. Part I discusses the general obligation of good faith under the UCC. Part II lays out and discusses how the specific UCC provisions on good faith serve one or more of the following functions: restrict the exercise of one-sided power in a contract, in order to avoid unfair or unexpected results; restrict the range of possible responses to defective performance or to an unexpected event, in order to salvage the contractual relationship or preserve the parties’ negotiating positions; impose a duty to mitigate losses, in order to avoid giving the aggrieved party a windfall beyond the expectations of the contract; and protect the innocent third party buyer or purchaser against claims of the original owner and other claimants. This functional analysis of good faith in the UCC results in clearer definitions of “good faith” in each of the four categories discussed through a determination of the function that good faith serves in each type of situation.

Keywords
Good faith, UCC, contracts, fair dealing, contractual duties, reasonable commercial standards, reasonable expectations, Restatement (Second) of Contracts, Second Restatement of Contracts

Disciplines
Contracts
FRONTISPICE ON GOOD FAITH: A FUNCTIONAL APPROACH WITHIN THE UCC

Christina L. Kunz†

The two essays that follow this frontispiece deal with areas of the law with thin jurisprudences on good faith. In many jurisdictions, employment law is still mired in the issue of whether good faith even applies to many situations.¹ Is there or is there not a duty of good faith? When does it occur, if at all? Does the good faith obligation arise as a matter of law or implied by the facts? Similar problems exist in the area of shareholder conduct in close corporations.² The resulting vacuum has led the courts to look to other areas of law for possible analogies. In the Uniform Commercial Code (UCC), for instance, these questions are resolved, at least on a global scale. The UCC expressly imposes an overall obligation of good faith as to the performance and enforcement of all contracts and duties within the UCC.³ It also notes particular areas of performance in which specific good faith duties are delineated.⁴ This is not to say that good faith is without controversy in the UCC. These express statutory rules on good faith have spawned many cases, as well as an impressive body of scholarship examining the workings and glitches of the UCC’s good faith doctrine.⁵ Thus, the UCC has, by default, become an active

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3. U.C.C. § 1-203. Unless otherwise indicated, all UCC cites in this essay are to the versions in effect as of June 1990.
4. See notes 34–63 infra and accompanying text.
laboratory of experiments on good faith. Even the "good faith" provision in the Restatement (Second) of Contracts grew out of this laboratory.  

Even within the UCC, however, the courts and commentators have been in a quandary as to how to define "good faith," because the statutory definitions lack precision and specificity. The resulting case law definitions are narrowly confined to a particular set of facts and therefore are not easily unified into a coherent overall definition. This essay proposes a functional approach to good faith, whereby the definition of good faith is determined by the function that good faith serves in each type of situation.

I. THE GENERAL OBLIGATION

Section 1-203 states: "Every contract or duty within [the UCC] imposes an obligation of good faith in its performance or enforcement." This obligation applies to all duties imposed by the UCC, as well as all contracts subject to the UCC. Note that the obligation does not extend to the process of contract negotiation and formation, although some commentators have argued that it should.

UCC cases are split on whether to permit a breach of good


6. See Restatement (Second) of Contracts § 205 comments a, c, d, & e (1979); 3A A. Corbin, Corbin on Contracts §§ 654A-I (Supp. 1990).

7. U.C.C. § 1-203.

8. See Union State Bank v. Woell, 434 N.W.2d 712, 717-20, 8 UCC Rep. Serv. 2d (Callaghan) 6 (N.D. 1989) (obligation of good faith attaches to a contract that is subject to the UCC; because an alleged oral agreement of a bank to lend money to the debtor failed for lack of certainty, no good faith requirement attached to the bank's conduct); First Bank of South Dakota v. Von Eye, 425 N.W.2d 630, 634-35, 6 UCC Rep. Serv. 2d (Callaghan) 1382 (S.D. 1988) (rejected farmer's argument that a bank, by refusing to continue to lend or even to advance expenses to harvest the current crop, had violated an obligation of good faith). Editors' Note: Parallel citation to the UCC Reporting Service has been added to help the reader locate the cases.

faith to serve as a basis for relief for the aggrieved party, if there is no basis for recovery other than section 1-203 (and perhaps section 1-106). The Eighth Circuit Court of Appeals, applying Missouri law, held that 1-203 imposes on each party the duty (1) to "do nothing destructive of the other" party's right to enjoy the fruits of the contract and (2) to do everything the contract presupposes it will do to accomplish the contractual purpose. Similarly, a later Missouri court held that in the performance and enforcement of any commercial contract, anything not regulated by contract should be done in such a way as to show good faith in carrying out what is expressed. A federal court held that both Colorado and Wyoming law allow an independent cause of action for breach of the duty of good faith and fair dealing and that the only situation in which this duty does not apply is in a contract clause expressly giving one party uncontrolled discretion on a particular matter. The California high court held that a bank had contracts with its customers who had signed signature cards;

10. U.C.C. § 1-106 states:

   (1) The remedies provided by this Act shall be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed but neither consequential or special nor penal damages may be had except as specifically provided in this Act or by other rule of law.

   (2) Any right or obligation declared by this Act is enforceable by action unless the provision declaring it specifies a different and limited effect.

11. Conoco Inc. v. Inman Oil Co., 774 F.2d 895, 909, 41 UCC Rep. Serv. (Callaghan) 1602 (8th Cir. 1985) (court found that Conoco breached its implied obligation of good faith and remanded the case for a determination of damages based upon losses to Inman when Conoco used its superior position to out-price Inman in bids and lure away Inman's largest consumer). See also 1 W. Hawkland, Uniform Commercial Code Series § 1-203:01, at 49 (Supp. 1989).

12. Rigby Corp. v. Boatmen's Bank & Trust Co., 713 S.W.2d 517, 533-34, 536-37, 4 UCC Rep. Serv. 2d (Callaghan) 19 (Mo. Ct. App. 1986) (bank did not breach its obligation of good faith when it required additional collateral to secure a guarantee; it acted on an honest belief that Rigby's ability to repay the loan was impaired, based on Rigby's weakening business operation and inability to pay major suppliers; in dictum, court noted that UCC provides for no other remedy for breach of obligation of good faith other than restoration of the status quo ante and since Rigby pleaded only breach of good faith under the UCC, remedy would be based on contract not tort) (full text does not appear in latter reporter).

these contracts allowed the bank to impose and change insufficient-fund charges. The court then subjected the bank to an obligation of good faith in imposing and changing such charges. Likewise, the Oregon court ruled that a bank could be held liable for lack of good faith to bank customers if it made charges greatly in excess of the actual costs of processing the checks drawn on insufficient funds.

On the other hand, a New York court and the Eighth Circuit Court of Appeals have refused to allow a cause of action or damages for breach of good faith, where no basis of recovery other than section 1-203 is present. Similarly, a Wisconsin court has rejected the idea that good faith can stand alone based on 1-203 without being attached to some other statutorily required conduct. It therefore held that a secured party could not be sued for bad faith when it failed to file a continuation statement of a financing statement, since this filing is not required under the UCC.

Article 1's all-purpose definition of good faith is "honesty in fact in the conduct or transaction concerned." However, many Articles of the UCC contain specific definitions of good

14. Perdue v. Crocker Nat'l Bank, 38 Cal. 3d 913, 924, 702 P.2d 503, 510, 216 Cal. Rptr. 345, 352 (1985). The California court and the Ninth Circuit Court of Appeals have also applied the holding in Perdue to other situations where one party to a contract has discretionary power affecting the other party's rights. Okun v. Morton, 203 Cal. App. 3d 805, 820, 250 Cal. Rptr. 220, 229 (1988) (plaintiff, an investor, entered into a contract with a restaurant operator to develop the Los Angeles Hard Rock Cafe; defendant, under the contract, had discretion to determine the structure of the business venture; the court subjected this discretion to an obligation to exercise the discretion in good faith and in accordance with fair dealing); California v. Chevron Corp., 872 F.2d 1410, 1414 (9th Cir. 1989) (applying California law, court held that where one party has discretionary power under the contract, the discretion must be exercised in good faith; where oil company had contractual freedom to post prices, setting an anticompetitive price was a breach of good faith to post a price at the true value of oil in a competitive market).


18. U.C.C. § 1-201(19).
faith that co-exist with the Article 1 definition. For instance, in a sale of goods under Article 2, a "merchant" must observe "reasonable commercial standards of fair dealing in the trade" as well as honesty in fact. In Article 7 on warehouse receipts and bills of lading, only one section specifies a standard of good faith—that of "good faith including observance of reasonable commercial standards."

The proposed draft of Article 3 defines good faith as "honesty in fact and the observance of reasonable standards of fair dealing." The current draft revising Article 4 states that this proposed Article 3 definition of good faith also applies to revised Article 4. In proposed Article 4A which governs the transfer of funds in the banking system, "good faith" is defined as "observance of reasonable commercial standards of fair dealing." Although the definitions in Articles 3 and 4A both omit "in the trade," possibly because it is not clear which trade is relevant, Article 4A refers to "reasonable commercial standards," while Article 3 refers to "reasonable standards."

These so-called definitions of good faith add very little certainty to the law, because the meaning of "good faith" must be further established in each litigated case by proof of these "reasonable commercial standards" or "reasonable standards," as well as "fair dealing." The resulting battles between expert witnesses give rise to very little useful precedent, because the case opinions likely will not be published and because the litigated situations are so specialized that they rarely occur again. In fact, as a commercial litigator bitterly complained at a recent ABA meeting, the use of good faith in the UCC seems to invite disputes and litigation, as well as increase attorney fees and the need for expert witness' testimony.

19. See id. § 1-201 comment 19.
20. Id. § 2-104(1).
21. Id. § 2-103(1)(b).
22. Id.
23. Id. § 7-404 (deletes "fair dealing in the trade") (bailee is relieved of liability resulting from good faith delivery or disposal of goods pursuant to the terms of the document of title or Article 7).
24. Id. § 3-103(a)(4) (Feb. 1, 1990 draft) (deletes "commercial" and "in the trade").
25. Id. § 4-104(3) (Feb. 1, 1990 draft).
26. U.C.C. § 4A-105(1)(f) (deletes "in the trade").
27. Unknown commentator, Article 2 roundtable discussion of the UCC Committee, ABA Spring Meeting of the Business Law Section (Boston, April 6, 1990).
From a litigator's perspective, you can see his point. Professor Kleinberger echoes that frustration from a corporate perspective in his essay in this symposium.\textsuperscript{28} However, the uncertainty in the good faith concept may well be having the opposite effect in the vast bulk of potential commercial disputes. Except in the tiny percentage of commercial cases that end up in the court system, parties may well be motivated to act well within the bounds of good faith, in order to avoid having to pay the costs associated with litigating good faith definitions and applications. As in other portions of the UCC,\textsuperscript{29} uncertainty probably "depolarizes" the disputing parties and brings them back to the middle—to the negotiating table.

II. Specific Good Faith Obligations: Functional Groups

At their most basic level, the specific UCC provisions on good faith serve one or more of the following functions:

1. restrict the exercise of one-sided power in a contract, in order to avoid unfair or unexpected results;
2. restrict the range of possible responses to defective performance or to an unexpected event, in order to salvage the contractual relationship or preserve the parties' negotiating positions;
3. impose a duty to mitigate losses, in order to avoid giving the aggrieved party a windfall beyond the expectations of the contract; and
4. protect the innocent third party buyer or purchaser against claims of the original owner and other claimants.

These functions are rarely specified in the UCC, but they implicitly "drive" the operational definition of good faith in each provision—that is, the applicable function greatly narrows the scope of relevant testimony and other considerations used to establish "reasonable commercial standards," "reasonable standards," and "fair dealing" in each individual controversy.

In each of the above categories, good faith is being used to

\textsuperscript{28} Kleinberger, supra note 2, at 1143.

\textsuperscript{29} For instance, an aggrieved party who is uncertain whether a breach really has occurred may decide to use a 2-609 letter, rather than suing immediately for damages, because of the possibility that there was no breach yet so that the so-called aggrieved party will then be in breach. The use of a 2-609 letter is an excellent means by which to open negotiations on problematic areas of performance. For a partial text of § 2-609, see note 49 infra.
preserve the reasonable (or at least supposed) expectations of the contracting parties at the time of contract formation. This unity of purpose lines up nicely with Professor Schmedemann's thesis in the next essay.30 She notes that Comment a from the Restatement (Second) of Contracts section 205 paraphrases good faith to mean "faithfulness to an agreed common purpose and consistency with the justified expectations of the other party." She postulates that this definition of good faith is actually the one closest to reality in employment law and therefore the most workable.31 This expectation approach also squares nicely with the contract construction rule that "[e]very contract implies good faith and fair dealing between the parties to it, and where an instrument is susceptible of two conflicting constructions, one which imputes bad faith to one of the parties and the other does not, the latter construction should be adopted."32

Thus, "good faith" in the UCC is really an umbrella for a collection of functional definitions of good faith, each of which is grounded in the parties' reasonable expectations at the time of contract formation.

The next part of this essay will examine each of the above four functions in detail, using examples primarily from Article 2,33 as well as the common law.

A. Restricting the Exercise of One-Sided Power in a Contract

In this set of rules, good faith restricts the exercise of one-sided power in a contract, in order to avoid unfair or unexpected results. In requirement and output contracts, the party in control of the quantity of goods has enormous power, bounded only by her own good faith and the requirement that the quantity cannot be "unreasonably disproportionate" to an estimate (or failing that, any normal or prior comparable amount).34 The same one-sided power is present in exclusive

30. Schmedemann, supra note 1, at 1120.
31. Id. at 1155.
33. This focus is primarily dictated by the author's areas of expertise. These functional groups include sections from other Articles of the UCC as well. See Hawk-land, Concordance, in 1 UCC SERIES 190 (1986).
34. U.C.C. § 2-306(1).
dealing agreements under the common law and the UCC, where the holder of the power must use "good faith best efforts" in rendering performance, especially when the level or amount of performance is unspecified.\textsuperscript{35} Likewise, if the contract gives one of the parties (either expressly or implicitly) the power to specify the particulars of performance (such as assortment of goods or shipping arrangements), those specifications "must be made in good faith and within limits set by commercial reasonableness."\textsuperscript{36} Moreover, if a party has the contractual power to accelerate payment or performance or demand some or more collateral "at will" or when she deems herself insecure, she can exercise that power only when she "in good faith believes that the prospect of payment or performance is impaired."\textsuperscript{37} In each of the above provisions, the party with the ostensible power to "make or break" the other party is reined in by the good faith provision and its accompanying provisions (e.g., "commercially reasonable," "not unreasonably disproportionate").

Similarly, in the UCC provision that abrogates the common law requirement of consideration to modify a contract,\textsuperscript{38} a comment reminds the reader that the general obligation of good faith applies here as elsewhere. The comment continues: "The effective use of bad faith to escape performance on the original contract terms is barred, and the extortion of a 'modification' without legitimate commercial reason is ineffective as

\textsuperscript{35} Id. § 2-306(2); Wood v. Lucy, Lady Duff-Gordon, 22 N.Y. 88, 91, 118 N.E. 214, 214–15 (1917) ("A promise may be lacking, and yet the whole writing may be 'instinct with [a good faith] obligation,' imperfectly expressed. . . . We are not to suppose that one party was to be placed at the mercy of the other. . . . Without an implied promise, the transaction cannot have such business 'efficacy, as both parties must have intended that at all events it should have.")

\textsuperscript{36} Id. § 1-208.

\textsuperscript{37} Id. § 2-209(1). This provision is frequently considered for application by analogy in jurisdictions contemplating the rejection of the pre-existing duty rule. See, e.g., Angel v. Murray, 113 R.I. 482, 322 A.2d 630, 636 (1974). Essentially, the good faith requirement here ensures that the party seeking modification is not playing a "hold-up game" in order to get the modification.

\textsuperscript{38} U.C.C. § 2-311(1).
a violation of the duty of good faith." In this section, good faith is essentially a substitute for the formality of consideration in the contract modification process and thereby serves to police the bargaining process. The abuse it seeks to prevent is the one-sided exercise of disproportionate bargaining power in coercing a modification. Note that this one-sided power is not power exercised in performing the existing contract, but instead one-sided bargaining power seeking to modify the existing contract.

Why does the UCC not require good faith during negotiations and contract formation, while it does require good faith during negotiations leading up to contract modification? Perhaps the answer lies in the Restatement (Second) of Contracts formulation of good faith discussed earlier. If good faith is "faithfulness to an agreed common purpose and consistency with the justified expectations of the other party," one can easily argue that the contracting parties both expected that neither party would attempt to coerce an unfair modification.

**B. Limiting Responses to Defective Performance or Unexpected Events**

In this set of rules, good faith restricts the range of possible responses to defective performance or an unexpected event, in order to salvage the contractual relationship or at least preserve the parties' negotiating positions. For instance, a comment to the UCC states that the seller's right to cure and the allowed instances of substituted performance are "particular applications of this general principle" of good faith. Both of these rules give the would-be breaching party a second chance and prevent the aggrieved party from immediately seizing on the breach, thereby serving the goal of fairness and in doing so, also preserving the contractual relationship a bit longer. Both of these results presumably line up with the parties' expectations at the outset of the contractual relationship.

The previously discussed provision requiring modifications

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40. See notes 7-9 supra and accompanying text.
41. See notes 30-32 supra and accompanying text.
42. Restatement (Second) of Contracts § 205 comment a (1979).
43. U.C.C. § 2-508.
44. Id. § 2-614.
45. Id. § 1-203 comment.
to be in good faith\(^{46}\) is also an instance of good faith serving to limit the more powerful party’s response to unexpected events.

Other sections serve a similar purpose. The tenderer (usually a bank) of an incomplete set of documents sent from abroad can demand payment from the buyer, even though the contract requires a complete set, if the tenderer furnishes an indemnity that the buyer “in good faith deems adequate.”\(^{47}\) Likewise, a buyer must reimburse a financing agency that in good faith honored or purchased a document that was defective, if the document appeared regular on its face.\(^{48}\) In each case, good faith rescues the would-be breaching party by restricting the aggrieved party’s range of responses.

Good faith can sometimes restrict both parties’ responses, as in the case of section 2-609.\(^{49}\) When one party has “reasonable grounds for insecurity” and the other party responds with what it claims is an “adequate assurance of due performance,” these matters must be judged by a good faith standard,\(^{50}\) as well as a commercial standard between merchants.\(^{51}\)

On the far edge, the Code excuses a seller from performance that has been made impracticable by the seller’s compliance in good faith with a governmental regulation or order, regardless of its eventual invalidity.\(^{52}\) Here, the buyer’s range of responses to the unexpected event or defective performance is completely restricted to a nullity; the excuse doctrine arguably implements the parties’ unarticulated expectations.

\(^{46}\) See notes 38–42 supra and accompanying text.
\(^{47}\) U.C.C. § 2-323(2)(b).
\(^{48}\) Id. § 2-506(2).
\(^{49}\) U.C.C. § 2-609(1) states:

A contract for sale imposes an obligation on each party that the other’s expectation of receiving due performance will not be impaired. When reasonable grounds for insecurity arise with respect to the performance of either party the other may in writing demand adequate assurance of due performance and until he receives such assurance may if commercially reasonable suspend any performance for which he has not already received the agreed return.

U.C.C. § 2-609(4) states: “After receipt of a justified demand failure to provide within a reasonable time not exceeding thirty days such assurance of due performance as is adequate under the circumstances of the particular case is a repudiation of the contract.”

\(^{50}\) Id. § 2-609 comments 3 & 4.
\(^{51}\) Id. § 2-609(2).
\(^{52}\) Id. § 2-615(a).
C. Imposing a Duty to Mitigate Losses

In this set of rules, good faith imposes a duty on the aggrieved party to mitigate losses, in order to avoid giving the aggrieved party a windfall beyond the expectations of the contract. These rules merely expand on the common law duty of the aggrieved party to avoid running up unnecessary damages. In a sense, these rules are a subset of the good faith sections that restrict the one-sided exercise of power,\textsuperscript{53} for the aggrieved party otherwise has a great deal of control over the mounting damages. Interestingly, the common law mitigation cases do not usually mention good faith, but instead set a standard of the judgment of a reasonable person in the shoes of the aggrieved party when he or she makes a choice that results in greater or at least different damages.\textsuperscript{54} This lends support to the idea that the UCC’s good faith “doctrine” is instead a collection of functional definitions under one umbrella. Here, the function is mitigation of damages.

A merchant buyer who has rightfully rejected or revoked acceptance must exercise good faith in following the seller’s reasonable instructions or in making reasonable efforts to resell the goods that are perishable or threaten to decline speedily in value.\textsuperscript{55} If a buyer decides to “cover” the seller’s breach, she must do so “in good faith and without unreasonable delay.”\textsuperscript{56} Analogously, upon the buyer’s breach, a seller who decides to resell the goods must do so “in good faith and in a commercially reasonable manner.”\textsuperscript{57} Additionally, after repudiation, the aggrieved party may choose from a range of remedies, as long as the choice is made in good faith.\textsuperscript{58}

D. Protecting the Innocent Third-Party Buyer or Purchaser

In this set of rules, good faith protects the expectation interest of the third-party buyer or purchaser at the expense of the expectations of the original owner and other claimants. This function of good faith is perhaps the least related to the expen-

\textsuperscript{53} See notes 34–42 supra and accompanying text.
\textsuperscript{55} U.C.C. § 2-603.
\textsuperscript{56} Id. § 2-712(1).
\textsuperscript{57} Id. § 2-706(1).
\textsuperscript{58} Id. § 2-610 comment 4.
tation interest in comment a of the Restatement (Second) of Contracts section 205, but the connection is nonetheless present. A good faith purchaser for value who purchases goods from a voidable title holder obtains good title and thereby prevails over the original owner.59 Likewise, a buyer in the ordinary course of business (of whom section 1-201(9) requires good faith) who buys from an entrustee/merchant who deals in goods of that kind obtains all rights of the entruster and thereby prevails over the entruster.60 These parallel results have been justified on grounds of estoppel and certainty, both of which enhance the negotiability of goods in commerce. Estoppel operates to bar the ownership claims of the original owner, who—at all the parties—stood the best chance of preventing the confusion that gave rise to competing ownership claims. Even if the facts do not compel a finding of estoppel, the common law has consistently favored the subsequent innocent purchaser or buyer, in order to lend certainty to the transfer of goods in commerce.61 However, another rationale is that the parties’ expectations at the time of contract formation are two-fold: (1) that the original owner took reasonable precautions to protect her ownership interest and (2) that the subsequent transfer was unencumbered by the original owner’s interests.

Note that good faith serves here to ensure the innocence and commercial “upstandingness” of the subsequent buyer or purchaser. The result in her favor is at the expense of another’s ownership claim—a seemingly unfair result made palatable by the innocence of the “winner.” Thus, even here the good faith requirement ensures fairness and thereby serves the parties’ original expectations at the time of contract formation.

Similarly, a buyer prevails over a levying creditor of the seller when the merchant seller retains possession of the goods in good faith and in the current course of trade for a commercially reasonable time.62 Here again the result favors the subsequent innocent buyer over the previous claimant because of the innocence of the winner and the policy favoring the free transfer of goods in commerce. The rationale is that each

59. Id. § 2-403(1).
60. Id. § 2-403(2).
62. U.C.C. § 2-402(2).
buyer or purchaser—the original owner and the subsequent buyer or purchaser—expected at the time of contract formation that her newly acquired interests would prevail over the interests of previous owners. The fact that supervening events deprived the original owner of her ownership interests does not change those original expectations.

CONCLUSION

Thus, a functional analysis of good faith in the UCC results in clearer definitions of "good faith" in each of the four categories discussed in this essay, because the underlying policies in each of the categories make the applicable meaning of "good faith" easier to ascertain. This analysis alleviates some of the uncertainty in the UCC's use of good faith, because it focuses on why the drafters included good faith in each UCC provision. Perhaps the study committee currently looking into the possibility of revising portions of Article 2 should re-examine the "grab-bag" use of good faith in the UCC; the meaning of these provisions would be clearer if the function of good faith were specified, rather than leaving it up to each reader's functional analysis.